The search for a euro safe asset *By Andy Hill*

Introduction

The idea of a public "safe asset" for the euro area is as old as the currency itself and was seen by some as a necessary, but missing, step in the process of monetary, banking, and capital markets union. The notion regained attention more recently in the wake of the euro sovereign crises, where a safe asset could not only provide emergency funding for stressed euro member economies but would also help to break the "doom loop" of the sovereign-bank nexus (*Brunnermeier et al., 2016*). More recently the discourse has begun to focus on the increasing demand for high-quality liquid assets in a more collateralised financial system. From a central bank perspective, the potential for a safe asset is seen as helping to make the euro a more investable currency while also facilitating the execution of monetary policy.

What makes an asset safe?

There has been much discussion around what should be the defining characteristics of a safe asset. The starting point is perhaps to distinguish safe assets from the broader class of high-quality liquid assets (HQLA). Generally it is held that a safe asset should not only be of the highest perceived credit quality, be deeply liquid, and have benchmark status (providing for a yield curve), but that it should be counter-cyclical in the sense that it should increase in value in stressed market conditions; importantly this should be due to a perception of quality and safety, rather than as a result of scarcity. Other features considered essential include the capacity to create a deep, liquid derivatives market, the best treatment under regulatory capital and liquidity requirements, as well as central bank eligibility with the lowest possible haircuts. To ensure enough liquidity, who holds and trades the asset is another important consideration, and it would seem desirable that it should provide short-term relative value opportunities for hedge funds as much as long-term investment appeal to buy-to-holds. The US treasury market provides the archetypal safe asset. In the euro area, German government bonds currently serve the role; but this is a relatively limited pool of assets and one that is set to become even smaller.

Designing a safe asset

While there may be broad agreement on the need for and desired characteristics of a euro safe asset, creating one is a lot more challenging. The first hurdle is that the possibility of a common, jointly guaranteed "eurobond" market has been roundly rejected on the grounds that this would reduce the incentive for "weak" economies to undertake necessary structural reforms and would undermine the stability and fiscal credibility of the euro area (*Issing, 2009*). Other considerations include not increasing the overall issuance stock of euro area sovereign debt and ensuring that there is not a detrimental shift in relative demand away from some domestic markets. Despite these potential limitations, a number of possible solutions have been put forward that continue to engage academics, policy makers, and regulators, as well as market participants. These various proposals can be grouped into four main approaches (*Leandro and Zettelmeyer, 2018*): tranching and pooling existing sovereign debt; pooling with preferred intermediary creditor status ("E-bonds"); pooling of existing sovereign debt, followed by tranching ("ESBies"); and issuance backed by a euro area budget (supranational issuance).

Tranching and pooling

The proposal here is that sovereign issuers could issue bonds in the form of senior and junior tranches. The senior tranches of euro area government bonds could then be purchased and pooled by an intermediary (or intermediaries) who in turn issues tradable securities with joint and several liability of the underlying sovereign issuers. This idea has been presented most visibly as the "blue bond proposal" (*Delpla and von Weizsäcker, 2010*), where the senior sovereign tranches are identified as "blue bonds" and the junior tranches as "red bonds". The critical consideration here is selecting the appropriate "subordination level". Proponents have suggested that blue bond status should apply to debt up to 60% of national GDP. The thinking is that the relative expensiveness of effectively subordinated national "red bond" issuance should provide an incentive for fiscal discipline. A variant on this theme is the "purple bond proposal", whereby sovereign issuers are incentivised to transition from existing national debt levels (which would be protected from restructuring) to achieving their 60% Fiscal Compact requirements over a 20 year period (gradually transitioning their outstanding stock of protected "purple bonds" to joint and several liability "blue bonds" and subordinated "red bonds").

E-bonds

The second approach also involves an intermediary absorbing and pooling sovereign issuance (either in the form of purchasing bonds in the secondary market or by buying bonds directly from national issuers) but without any tranching of the underlying debt. Rather, the purchasing intermediary, that would subsequently issue securities against its pooled holdings, would be a public entity with preferred creditor status, such as the European Stability Mechanism (ESM) or International Monetary Fund (IMF). Subordination is effectively created by providing the intermediary with first claim on sovereign holdings. The amount of underlying sovereign bonds that can be purchased from any issuer is limited in terms of their debt-to-GDP ratio (effectively setting the "subordination level"). This approach to creating a euro safe asset, dubbed "E-bonds", garnered a fair amount of official support following the sovereign debt crisis.

ESBies

The third proposal, and perhaps the one which has received the most attention more recently, also applies tranching and pooling, only in this case in the form of creating securitised assets. The premise is that intermediaries – whether private or public – would be able to purchase a pool of underlying sovereign debt and issue tradeable securities backed by the underlying portfolio. These securities would be issued in tranches, with a senior and junior tranche (and potentially a mezzanine tranche). Purchases would be based along the lines of the ECB capital key and analysis suggests a senior tranche consisting up to 70% of the underlying face value of debt.

Dubbed "European Senior Bonds" ("ESBs" or "ESBies"), the most concrete proposal has been put forward by Brunnermeier et al. (2017) in the form of "Sovereign Bond-Backed Securities" (SBBS), and has received the detailed scrutiny and consideration of the European Systemic Risk Board (ESRB) High-Level Task Force as well as a public consultation by the European Commission. In May 2018 the European Commission put forward proposed regulation to facilitate the creation of SBBS and ensuring that they would receive the same regulatory treatment as sovereign bonds. Despite this attention, and some official sector enthusiasm, ESBies have been heavily criticised (and largely dismissed) by both private and public stakeholders. Identified challenges include the potential for creating a liquid market (with the possibility of multiple issuers and a lack of fungibility) as well as the ability to sell junior tranches under stressed conditions.

Supranational bonds

The fourth proposed approach involves creating safe assets in the form of supranational bonds that are issued either by an underlying euro area budget or a leveraged euro area sovereign wealth fund (*Ubide 2015*). Seniority for such bonds would be created by providing the budget or fund with first claim on any related revenues (such as tax income or member state EU budget payments). Such issuance (also known as "stability bonds") could also be used to support euro area fiscal stimulus. This has also been cited as a potential stepping stone toward the creation of a longer-term eurozone treasury.

From proposal to reality

While there are a range of alternative proposals under consideration, and a series of challenges and limitations to circumnavigate, it would seem that there is broad consensus among public and private stakeholders of the benefits, and even the need, to create a euro safe asset. In doing so, a number of questions still need to be answered. These include whether issuance should be demand or supply led, the involvement of the private sector in its creation, and whether a safe asset market should be developed gradually or if a "big bang" approach should be taken. Variations on the four main proposals also deserve consideration, such as a proposed "temporary eurobill fund" (TEF). Effectively the pooling of short-term euro area issuance, this might not only be a manageable means of testing the water for safe assets, but it could also ease some of the strain being borne by the repo market in intermediating collateral flows, as well as creating a term risk-free reference rate for the euro area.

What seems certain, however, is that the discussions around a euro safe asset are likely to intensify as its creation becomes viewed as ever more critical for completing the triumvirate of monetary, banking, and capital markets union.

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